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## THE WISCONSIN INCOME TAX

BY KOSSUTH KENT KENNAN, LL.D.,

Attorney at Law, Milwaukee, Wisconsin.

Prior to 1912, the history of state income taxes in this country failed to disclose a single instance in which the tax had been successful as a revenue producer or had justified itself as a practical or desirable method of taxation. No one can peruse Dr. Kinsman's excellent monograph on the *Income Tax in American Commonwealths* without being struck by the uniformly meagre and unsatisfactory results obtained. Of all the states Virginia has probably had the largest experience with income taxes, yet the amount raised annually in that state for the past twenty years will average far below \$100,000. This, too, in spite of the fact that the state has taxed incomes for nearly three-quarters of a century and that during that period nearly every known form of income taxation has been tried.

In the face of these experiences it is somewhat remarkable that the people of Wisconsin should suddenly—and apparently spontaneously—reach the conclusion that a state income tax was necessary and desirable.

*History.* In 1903 a joint resolution to amend the constitution so as to authorize the levy of an income tax was introduced in the legislature and was passed in both houses with but one dissenting vote. Both political parties favored the amendment in their platforms, but there was no discussion of the subject and it seemed to be taken for granted by the politicians that the theory of income taxation was one of those things which could be safely advocated without any danger of its ever going into actual operation. The first amendment proved abortive owing to a technical defect in the required notice of election. In 1905 the resolution was again introduced and passed with but little debate, the proposed amendment being as follows:

"Taxes may also be imposed on incomes, privileges and occupations, which taxes may be graduated and progressive and reasonable exemptions may be provided."

When the amendment came up for legislative ratification in 1907 there was only one vote against it and, when put to the test of popular vote in 1908, it was carried by the decisive majority of 85,696 to 37,729.

A first draft of a state income tax law was introduced at the legislative session of 1909. A "recess committee" of three senators and four assemblymen was appointed to investigate the subject and report in two years to the next session. This committee held public meetings in all the larger cities of the state and invited discussion, suggestions and criticism from all possible sources. When the bill reached the legislature in 1911, the first real opposition to the measure made itself felt. Upwards of sixty amendments were proposed,—many of them of such an absurd character as to indicate that they were made solely to defeat the law. Toward the end of the session the need of expert assistance was felt and Dr. Kinsman was engaged to redraft the bill while the members of the tax commission rendered valuable assistance.

The Wisconsin income tax law was passed in June of the year 1911 and by its terms was made to apply to all income earned in that year. In the suit which was immediately brought in the state supreme court to test the constitutionality of the law, a great many points were raised against the validity of the act, and the case was argued by lawyers of learning and ability. The court, in its opinion sustaining the law, said:

By this Act the legislature has, in substance, declared that the state's system of taxation shall be changed from a system of uniform taxation of property (which so far as personal property is concerned has proven a failure) to a system which shall be a combination of two ideas, namely, taxation of persons progressively, according to ability to pay, and taxation of real property uniformly, according to value.

The Wisconsin income tax act is quite lengthy and only a few of its more salient features can be mentioned.

*Income.* The law begins with the usual futile attempt to define income. For example, it provides that the term "income" shall include rent, interest, wages, dividends, profits and royalties "and all other income (!) of any kind derived from any source whatever except as hereinafter exempted."

The inclusion under the head of income of "the estimated rental of residence property occupied by the owner thereof" has been the cause of much complaint. There seems to be a considerable class

of people whose mental processes are not quite equal to the task of understanding this requirement.

*Deductions.* The usual deductions for business expenses, losses, dividends, interest paid on indebtedness, interest from exempt bonds, salaries of federal officials, and pensions are allowed. Amounts paid for taxes may also be deducted but only such as are paid upon the property which produced the income. In other words the taxes paid on unproductive property cannot be deducted from gross income. Moneys received from life insurance by persons legally dependent on the deceased are exempt up to \$10,000.

*Exemptions.* The exemptions consist of: \$800 for a single person; \$1,200 for husband and wife; \$200 for each child under eighteen years of age; \$200 for each dependent.

These exemptions apply only to individuals who are residents of the state. Non-residents and corporations are required to pay the tax on their whole net income arising from sources within the state.

*Rates.* The scale of rates for individuals is progressive from one to six per cent, the latter figure being the maximum. While the increase in percentage of rate is accelerated with the progression, the basis of taxable income to which the rate applies advances uniformly by steps of \$1,000. This may be illustrated by the following table:

	TAXABLE INCOME	RATE, PER CENT	TAX	TOTAL TAX	TRUE RATE ON WHOLE AMOUNT, PER CENT
1st.....	\$1,000	1	\$10.00	\$10.00	1.0
2nd.....	1,000	1½	12.50	22.50	1.125
3rd.....	1,000	1½	15.00	37.50	1.25
4th.....	1,000	1½	17.50	55.00	1.375
5th.....	1,000	2	20.00	75.00	1.5
6th.....	1,000	2½	25.00	100.00	1.6667
7th.....	1,000	3	30.00	130.00	1.8571
8th.....	1,000	3½	35.00	165.00	2.0625
9th.....	1,000	4	40.00	205.00	2.2778
10th.....	1,000	4½	45.00	250.00	2.5
11th.....	1,000	5	50.00	300.00	2.7273
12th.....	1,000	5½	55.00	355.00	2.9582
13th.....	1,000	6	60.00	415.00	3.1923
15th.....	1,000	6	60.00	535.00	3.5667
20th.....	1,000	6	60.00	835.00	4.175

These rates are not as high as they may seem at first glance. For example, although the rate prescribed for the twelfth thousand is  $5\frac{1}{2}$  per cent, the amount of tax to be paid on \$12,000 would be \$355, or 2.9582 per cent of that sum. The point at which the maximum rate is reached corresponds closely with that at which it is attained in a number of foreign countries. For example, the average amount of taxable income at which the maximum rate is reached in Prussia, Saxony, Norway, Sweden, Denmark, England and six of her colonial possessions is \$14,390.

The rates for corporations are, at the beginning, practically double those for individuals and the maximum rate of six per cent is reached with the seventh thousand of taxable income. As in the case of individuals, the grades or steps of taxable income are uniform at \$1,000 each and the rate advances from 2 per cent to the first \$1,000 to  $2\frac{1}{2}$  for the second, 3 for the third,  $3\frac{1}{2}$  for the fourth, 4 for the fifth, 5 for the sixth and 6 for all above \$6,000.

This scale of rates was adopted by the legislature of 1913 as a substitute for a scheme contained in the original law which attempted to adjust the rates according to the proportion which the net income bore to the assessed value of the property used in producing the income. The original plan was found to be impracticable and to some extent inequitable. During the year it was in force it was found that the average rate paid by individuals was 1.96 per cent while the average for corporations was 5.4 per cent. Under the present law a corporation would need to have a taxable income of \$30,000 before the last mentioned rate would be reached; but that sum is more than six times the average corporate taxable net income.

*Penalties.* The severest of the penalties are those prescribed for the violation of the secrecy of returns. They include fines of not less than one hundred nor more than five hundred dollars, imprisonment in the county jail from one to six months and imprisonment in the state prison for not more than two years, in the discretion of the court.

For failure to make returns, or intentionally false or fraudulent returns the penalties are a fine not to exceed five hundred dollars, or imprisonment not to exceed one year, or both in the discretion of the court. In addition authority is given to double the amount of the omitted tax and this is the only penalty which has thus far been enforced. A somewhat curious provision is that which makes

the assessor of incomes liable to a fine of five dollars for every question unanswered on an income tax return. It is hardly necessary to state that no prosecutions have been attempted under this provision of the law.

*Administration.* The distinguishing feature of the Wisconsin income tax law is the prominence given to the scheme of administration. Of the seventeen closely printed pages which contain the law in pamphlet form about two-thirds are devoted to the methods by which the law is to be administered. It was realized that the failure of all state income taxes in the past was directly traceable to lax methods on the part of local officials, and this danger was sought to be avoided by securing a higher degree of centralization. To this end the administration of the law was placed wholly in the hands of the permanent state tax commission. This commission appointed the writer of this article as "supervisor of the income tax" and the arduous task of arranging all the administrative details of a new and untried system was placed in his hands.

*Assessors.* In accordance with the provisions of the law assessors of income were appointed by the tax commission. These assessors were selected after a rigid civil service examination, from a large number of applicants, and with special reference to character, fitness and ability. No attention was paid to the political affiliations of the applicants. The appointments were for three years and the salaries ranged from \$800 to \$3,600. In the populous and wealthy counties in the southern portion of the state one assessor was appointed for each county; but in the more sparsely settled northern portions an assessment district was made to include two or even three counties. The result was that it was found necessary to appoint only thirty-nine income tax assessors for the seventy-two counties in the state. In a few of the more important counties the assessors were permitted to have assistant assessors and necessary clerical assistance. The office of county supervisor of assessment for the general property tax was abolished and the duties of such officers were transferred to the income tax assessors. The Wisconsin income tax assessor, therefore, really serves in a dual capacity—as assessor of income tax and as supervisor of the assessment of the general property tax.

*Returns.* Six different forms of return are used, separate blanks being provided for (a) individuals, (b) guardians, trustees, execu-

tors, agents, receivers, (c) firms and copartnerships, (d) corporations, (e) farmers and dairymen and (f) wage earners, salaried men and other individuals deriving their income from personal services.

All returns of incomes by *firms* and *individuals* are to be made to the income tax assessors before the first of March in each year. Upon receipt of these returns they are carefully edited and the assessors make an assessment of the tax in each case. If the assessor has reason to believe that a return is erroneous or does not disclose the full amount of income he can increase the amount upon which the tax is based upon giving written notice to the taxpayer. A board of review of three persons is appointed by the tax commission for each district. An appeal lies from the decision of the assessor to the board of review, and then from the board of review to the tax commission. It should be noted, however, that very few such appeals have been taken.

The corporations are assessed directly by the tax commission and are given a right of appeal to the circuit court of Dane County, the county in which the capital of the state is situated.

*Information at Source.* The Wisconsin tax commission has organized a system of "information at the source" which has been found to work very efficiently and smoothly. When the forms for income tax returns are given out they are accompanied by blanks upon which the taxpayer is required to fill out the name and address of every person to whom a salary or wages to the amount of seven hundred dollars or more has been paid during the year and the amount paid in each case. There is an additional blank for corporations upon which the names and addresses of all stockholders to whom dividends have been paid, together with the amount paid, are given. In like manner claims for interest paid on indebtedness must be accompanied by a statement of the name and address of the person to whom such interest was paid. The information thus obtained by the tax commission is classified and arranged so as to be furnished to the assessors of the respective districts where the recipients of the wages or dividends reside.

This plan, which is not provided for in the law, but has been worked out by the tax commission under its general authority to make needful regulations, operates as a three-fold check. In the first place it will show whether any excessive salaries are being paid to officers of the corporations; in the second place it enables the

commission to test the correctness of the corporate deductions for wages, salaries and dividends paid; and in the third place it calls attention to any omission on the part of individuals to report the full amount received by them as interest, wages or dividends. The deterrent effect of such a system will be at once apparent, and the tax commission thus becomes a sort of clearing house where a vast amount of information centers and is redistributed to the district assessors.

*Exemption of Intangibles.* It should be emphasized that the Wisconsin income tax law is not an additional tax supplemental to the general property tax, but is a substitute for the tax heretofore levied—or attempted to be levied—upon intangible personal property. Coincident with the passage of the income tax law, the general laws were amended so as to exempt from taxation: (a) Moneys; (b) Stocks and bonds; (c) “All debts due from solvent debtors, whether on account, note, contract, bond, mortgage or other security, or whether such debts are due or to become due.”

In order that the owner of *tangible* personal property should not be placed at a disadvantage as compared with the owner of intangibles, the income tax law provides that the receipts for general taxes paid on personal property may be used as cash in paying the income tax. This is called “offsetting.” For example, if a person’s income tax is, say, \$27 and he has paid taxes on personal property to the amount of \$15 he can turn in the personal property tax receipt and \$12 as full payment of the income tax.

*Application of Proceeds.* The Wisconsin income tax is not a *state* income tax in the sense that it is applied to *state* purposes. The law provides that the moneys raised by means of the tax shall be apportioned in the proportion of 70 per cent to the local taxing unit (city, village or town) where it was collected; 20 per cent to the county and the remaining 10 per cent to the state. It was thought that the 10 per cent given to the state would about cover the expenses of administration, but the amount actually received was more than double the cost of collection. In the first year of the tax when the expenses were unusually large the total cost of administration (about half of which was incurred in connection with general taxes) was approximately \$100,000, while the state’s share of the tax actually collected was \$220,000.

The amounts of income taxes assessed, both individual and cor-



porate, are certified to the respective county clerks by the tax commission and assessors and again by the county clerks to the city, town and village clerks.

There has been some complaint on the ground that the insertion of the amount of income tax in the tax rolls was a violation of the secrecy required by the law. But the tax rolls must, under the general law, be public records and the amount of income tax paid is far from being a reliable index to one's financial condition. A large income may be derived from dividends, the tax upon which is paid by the corporations at the source, so that the individual income tax may be very small. Even the income of salaried persons may be so reduced by exemptions and deductions that the amount of tax throws no light upon the total amount of gross income received.

*Income from Interstate Business.* A leading authority on income taxation has suggested that an insuperable obstacle to the success of a state income tax would be the practical impossibility of drawing the line between interstate and intrastate income. Income flows back and forth across state lines so constantly that the question of its situs for purposes of taxation is a very complicated one. The solution of this problem which has been attempted in Wisconsin presents some interesting features and is outlined in the following quotation from the law:

In determining taxable income, rentals, royalties and gains or profit from the operation of any farm, mine or quarry shall follow the situs of the property from which derived and income from personal service and from land contracts, mortgages, stocks, bonds and securities shall follow the residence of the recipient. With respect to other income, persons engaged in business within and without the state shall be taxed only upon such income as is derived from business transacted and property located within the state, which may be determined by an allocation and separate accounting for such income when made in form and manner prescribed by the tax commission, but otherwise shall be determined in the manner specified in subdivision (e) of subsection 7 of section 1770b of the statutes as far as applicable.

The section of the statutes referred to authorizes a computation by taking the gross business in dollars of the corporation in the state and adding the same to the full value of the property of the corporation located in the state. The sum thus obtained is used as the numerator of a fraction—the denominator of which is to consist of the total gross business in dollars of the corporation both with-

in and without the state added to the full value of the property of the corporation within and without the state. The quotient of the numerator divided by the denominator is a decimal which indicates the proportion of the whole net income which should be apportioned to Wisconsin.

This somewhat complicated and arbitrary method is applied quite frequently, but sometimes leads to grotesque results. For example, a foreign corporation may have a large amount of property in Wisconsin but its business, so far as Wisconsin is concerned, may be carried on at a great loss. Nevertheless, if profits have been large in other states, the application of the above rule might show a considerable income for Wisconsin. Yet on the whole the plan has worked more smoothly than was to be expected. In speaking of interstate corporations the report of the tax commission for 1912 uses the following language:

The Wisconsin income tax has, on the whole, encountered very little difficulty with this class of taxpayers, and such difficulty as has been encountered can be avoided very largely in subsequent years. . . . The large foreign corporations have dealt quite as fairly with the Wisconsin income tax as any other class of taxpayers. It is just as easy to assess the big interstate corporations under the income tax as it is under the property tax.

*Results.* As a fiscal measure the Wisconsin income tax has far exceeded the expectation of its most enthusiastic sponsors. When the law went into effect many doleful predictions were made as to the probable yield of the tax. It was freely prophesied that Wisconsin would only duplicate the experiences of other states and that the amount collected would scarcely suffice to pay the cost of collection. Even the friends of the measure did not estimate the probable yield at over one million dollars, and it was realized that the administration of the tax would be attended by many peculiar difficulties in the first year of its operation.

Under these circumstances there was no small surprise when it was found that the income tax levy of the first year (based on income of 1911, collected in 1912) amounted to the very respectable sum of \$3,501,161.46. In the second year the amount was \$4,091,090.30.

This remarkable showing will perhaps be better appreciated when it is remembered that the Civil War income tax yielded for the first year, 1863, only \$2,741,858 or about 78.3 per cent of the first

year's levy in Wisconsin. The amount levied on corporations by the Wisconsin law for the year ending December 31, 1912, was \$2,793,605.40, while for the year ending June 30, 1912, the federal excise tax on corporations in Wisconsin amounted to only \$575,550.61, or about one-fifth. In this connection it must be remembered that 29 per cent of the amount of net income assessed against corporations under the federal law was from railroads, public utility corporations, insurance companies and national banks, all of which were exempt from the state income tax. In the first year of the federal income tax law the amount collected from individuals in Wisconsin was \$220,642 and from corporations \$497,785, or a total of \$718,427—about one-sixth of the amounts assessed under the state law. Of course the differences in rates and exemptions must be taken into account, but, leaving those elements out of the computation, it would seem evident that the amount of taxable income discovered by the state system in the case of corporations was materially greater than that brought to light by the federal methods.

The amounts actually collected in Wisconsin have very greatly overbalanced the losses occasioned by the exemption of intangible personal property. As the result of a careful and thorough investigation, recently made under the direction of the tax commission, it was found that the decrease in the personal property assessment caused by the exemption of intangibles was \$40,077,695 and the corresponding property tax which would have been collected on that sum was \$703,589.35, or about one-sixth of the amount of income tax levied. It should be stated, however, in fairness, that the amount of income tax *collected* is much less than the amount *levied*. This is due to the privilege of "offsetting" personal property tax receipts. It is estimated by the tax commission that, for the year 1912, about 37 per cent of the whole income tax was paid by personal property tax receipts.

The *average* rate of taxation upon individuals and firms was 1.96 per cent and upon corporations 5.4 per cent. About 40 per cent of the whole tax is assessed in Milwaukee County and 80 per cent is assessed in the seventeen counties which contain the larger cities.

The total cost of administering the income tax for the year 1912 was \$92,480.29 and this included payment for the salaries and expenses of the income tax assessors in connection with the assessment of the general property tax.

But the success of any tax law should not be measured wholly by its financial results. If the scheme of taxation proposed does not commend itself to the average citizen as just and equitable, it can hardly be expected to be permanent in a country where the power of making and unmaking the laws is vested in the people. Of all fiscal measures an income tax law is one of the most direct in its application and the first enforcement of such a law is apt to evoke violent opposition from those most affected by it. In this respect Wisconsin was no exception. In the first year of the operation of the law a state election was held and the question of income tax or no income tax was the predominant and almost sole issue of the campaign. Both political parties were split into factions, but the Republican candidate for governor espoused and defended the income tax while his Democratic opponent waged a bitter war against it. The vote at the polls would seem to indicate that public sentiment favored the tax. At the present writing another campaign is in progress with the same Democratic candidate for governor in the field but he has taken pains to announce publicly that he will not oppose the income tax. The consensus of public opinion throughout the state seems to be that "the income tax has come to stay," and that, however objectionable in some respects, it is a distinct improvement upon the personal property tax which it has supplanted.

*Objections and Criticisms.* It is too much to expect that a law drawn by men who had no practical acquaintance with the subject and but little theoretical knowledge should be complete and perfect in all its details. Such a law can only approximate perfection after years of careful adjustment and re-shaping to make it conform to the human equation which, after all, is bound to be the controlling factor in its success or failure.

Some of the objections most loudly urged against the state income tax are precisely those which deserve the least consideration. For example, the assertion that the law is inquisitorial may be answered by saying that it is not nearly as inquisitorial as the personal property tax would have been if it had been strictly enforced. The statement so often made that it "makes a nation of liars" can easily be shown to be false. Any person who, like the writer, has had occasion to review and test the correctness of thousands of income tax returns will be impressed by the evident truthfulness and honesty with which the vast majority of such returns have been prepared.

In one thousand returns which were defective or erroneous it was found that more than one-third contained errors which had the effect of *increasing* the tax. Of the remainder the very great majority were erroneous through obvious ignorance or misunderstanding of the provisions of the law. The number in which there was any evidence of a deliberate attempt to defraud the law was very small—safely under five per cent.

The objection that the law taxes thrift is equally applicable to all tax measures. The predictions that the enforcement of the law would drive capital from the state have not proved correct to any appreciable extent. But there are objections to the law in its present form which are sufficiently serious to call for careful consideration at the hands of the legislature. For example, the double rate on corporations does not appear to be justified by the comparatively slight advantages which accrue from incorporation. The provisions for appeals are not satisfactory to the public as there is an impression that the tax commission is, so to speak, "judge of its own cause," and is disposed to favor the state as against the taxpayer in doubtful cases. The rule for the taxation of income from interstate business is somewhat crude and does not always work out fairly. The inclusion under the head of income of gifts and inheritances is hardly scientific, and the same may be said of income which had accrued and become payable before the law went into effect and was therefore more in the nature of capital. The whole question of wasting assets, particularly in the case of mines, awaits some more satisfactory solution than is offered by the Wisconsin law.

These, and other minor points which might be mentioned, are some of the questions with which the legislature will have to deal if the Wisconsin law is to be made a model for other states.